IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

No. 16,341

JOE L. SCHMITT, JR., and HELEN M. SCHMITT, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*

Petition to Review a Decision of The Tax Court of the United States

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PETITIONERS' BRIEF

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PETITIONERS' BRIEF

JURISDICTIONAL STATEMENT

Jurisdiction of the Tax Court

Petitioners on review filed Federal Income Tax Returns for the taxable years 1949, 1950, and 1951 with the Collector of Internal Revenue for the District of Arizona at Phoenix, Arizona, (R. 137). On September 2, 1955, the Commissioner of Internal Revenue sent to petitioners, by Registered Mail, a notice of deficiency in which he deter-

mined that the petitioners owed deficiencies in income tax as follows:

Year	Deficiency
1949	$ 31.44
1950	9,357.72
1951	2,643.40
Total	$12,032.56

(R. 11)

Thereafter, on November 25, 1955, petitioner duly filed appeals from said determination with the Tax Court of the United States (R. 3-19). The case was tried before the Tax Court on March 25, 1957. The Tax Court promulgated its findings of fact and opinion (R. 136-162) and entered its decision ordering and deciding that the taxpayers owed deficiencies in income tax as follows:

1949	$ 31.44
1950	4,382.06
1951	1,166.48

The decision was entered August 4, 1958, (R. 163).

Jurisdiction of Court of Appeals

Petition for review was filed October 24, 1958, to review the order and decision entered by the Tax Court on August 4, 1958, (R. 164-168). Jurisdiction is conferred upon this Court by Sections 1141 and 1142 of the Internal Revenue Code of 1939, and Sections 7482 and 7483 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Petitioner Joe L. Schmitt, Jr., invented a mechanical process utilizing tabulating cards to evaluate single entry information, which produces double entry bookkeeping and accounting statements. During the years here involved,

he sold all his rights in this system known as the "Exact-O-Matic System", in certain territories. Petitioners reported the proceeds from the sales as the sale of a capital asset. The Commissioner of Internal Revenue determined the proceeds from the sales were ordinary income.

The question for decision is: Were the proceeds from the sales of the Exact-O-Matic System during the years here involved taxable as capital gains or as ordinary income?

STATUTES INVOLVED

Internal Revenue Code of 1939

(for the taxable years beginning after December 31, 1941)

SEC. 117. CAPITAL GAINS AND LOSSES

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock of trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (1), or any obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivision thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer.

* * * * *

(for taxable years beginning after September 23, 1950)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or real property used in his trade or business;

(C) a copyright; a literary, musical, or artistic composition; or similar property; held by—

(i) a taxpayer whose personal efforts created such property, or

(ii) a taxpayer in whose hands the basis of such property is determined, for the purpose of determining gain from a sale or exchange, in whole or in part by reference to the basis of such property in the hands of the person whose personal efforts created such property; or

* * * * *

(q) (as added by Section 1 of the Act of June 29, 1956, c. 464, 70 Stat. 404) *Transfer of patent rights.*—

(1) *General rule.*—A transfer (other than by gift, inheritance, or devise) of property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than 6 months, regardless of whether or not payments in consideration of such transfer are—

(A) payable periodically over a period generally coterminous with the transferee's use of the patent, or

(B) contingent on the productivity, use, or disposition of the property transferred.

* * * * *

(4) Applicability.—This subsection shall apply with respect to any amount received, or payment made, pursuant to a transfer described in paragraph (1) in any taxable year beginning after May 31, 1950, regardless of the taxable year in which such transfer occurred. As amended Jan. 28, 1956, c. 18, § 1, 70 Stat. 8; June 29, 1956, c. 464, § 1, 70 Stat. 404.

STATEMENT OF CASE

Petitioner, Joe L. Schmitt, Jr. (hereinafter sometimes referred to as petitioner), and Helen M. Schmitt are, and were during the years 1949, 1950 and 1951 husband and wife. They filed joint income tax returns for those years with the then Collector of Internal Revenue at Phoenix, Arizona (R. 137).

Petitioner has engaged in accounting work since 1925 in the state of Arizona and particularly in and around the City of Phoenix (R. 55, 137). He was the inventor and sole owner of certain applications for patents, copyrights and registrations referred to under the trade name "Exact-O-Matic System". The system is an accounting method described as being an automatic, mechanical process utilizing tabulating cards to evaluate single entry information which produces double entry bookkeeping and accounting statements. The Exact-O-Matic is designed for use by accountants who render bookkeeping services to small businesses (R. 22, 81-82, 85-86, 137-138).

An accountant who is trained in the Exact-O-Matic System with Remington-Rand tabulating equipment and the general accounting wiring unit designed by the petitioner can economically service a large number of small business accounts (R. 82). In connection with the Exact-O-Matic System, petitioner made applications for patents, obtained and registered trade or service marks, and ob-

tained certain copyrights in connection with literature describing the Exact-O-Matic system and the procedure manual for using this system. In addition, the petitioner designed a general accounting wiring unit to be used in the printing tabulator of the Remington-Rand Tabulating Machine for use in connection with the Exact-O-Matic System. Petitioner had an agreement with Remington-Rand, Inc., whereby Remington-Rand agreed not to manufacture, lease, or sell the general accounting wiring unit to anyone except the franchise holders of the Exact-O-Matic System (R. 62-67, 138, 149-150).

During the years here involved, petitioner entered into eleven agreements whereby he granted to the assignees the exclusive right, privilege, and franchise to use and sell the Exact-O-Matic System throughout a designated or specified territorial area. These agreements were entitled "Territorial Assignments of Patent". By these assignments the petitioner assigned all his rights in the trade or service marks, name, patents, and patent applications in perpetuity with no provision for reversion except for nonpayment of the consideration set forth in the agreement. Specifically, under paragraph 2 of the Territorial Assignment of Patent, it was provided: (R. 24-25)

> "Assignor hereby grants unto Assignee the exclusive right, privilege and franchise to use and sell the said Exact-O-Matic System (District, Unit A and Unit B), throughout the Territorial area described as follows:
>
> " * * * and to use, employ, and operate any and all methods, procedures, and processes covered by said Patents, Patents pending, Registration, and Copyrights, within and throughout the Territorial Area, and also any reissues or extensions thereof during the entire term of said Patents, Registrations, and Copyrights, subject, however, to the conditions and covenants hereinafter set forth. For the purposes of this agreement, the designation 'Patent' is hereby defined to mean Patents, Patents pending, Registrations, Copyrights, and any oral or written agreement between

the said 'Assignor' and Remington-Rand, Inc., a Delaware Corporation, heretofore or hereinafter issued to Assignor, relating to double entry machine bookkeeping methods, procedures, and processes."

In consideration for said assignments, the assignees paid petitioner during the years 1949, 1950 and 1951 lump sum payments in the amount of $7,965.02, $38,000.00 and $11,000.00, respectively. In addition, during the years 1950 and 1951, as a part of the purchase price for the rights granted under the territorial assignments, the petitioner received from the territorial assignees the sums of $7,500.00 and $1,800.00, respectively, for the licensing by the territorial assignees of "District Franchises" within their territorial areas. These payments were made by the territorial assignees to the petitioner under the licensing of district franchises pursuant to paragraph 6 (a) of the territorial assignment of patents. Under the territorial assignments the assignees were given complete authority to sell or license the rights they had received from the petitioner in their territorial areas. It was further provided that the territorial assignees would collect royalties from the district franchise holders or licensees for use of the Exact-O-Matic System and that when received the territorial assignee would pay to the petitioner-assignor fifty per cent of the gross royalties collected. This was provided for by paragraph 6 (b) of the territorial assignment of patents. All amounts paid to petitioner as royalties under paragraph 6 (b) were reported by petitioner as ordinary income and are not involved in this proceeding (R. 27-28, 43, 91, 94).

The petitioner reported the proceeds from the sales under the territorial assignments of patents as long-term capital gain. The Commissioner determined that the proceeds were taxable as ordinary income. The Tax Court sustained the Commissioner and held that the petitioner did not dispose of all substantial interest in the system (R. 160-161).

SPECIFICATION OF ERRORS

The Tax Court of the United States erred:

1. In determining that there are deficiencies in income tax for the years 1949, 1950, 1951 in the amounts of $31.44, $4,382.06, $1,166.48, respectively.

2. In holding and deciding that the proceeds from the sale by petitioner, Joe L. Schmitt, Jr., of his rights in the Exact-O-Matic System to territorial assignees during the years 1949 to 1951, inclusive, were taxable as ordinary income instead of at capital gains rates.

3. In failing to hold that the proceeds from the sale by petitioner, Joe L. Schmitt, Jr., of his rights in the Exact-O-Matic System to territorial assignees during the years 1949 to 1951, inclusive, were taxable as the sale of a capital asset.

4. In failing to hold that the proceeds from the sale by petitioner, Joe L. Schmitt, Jr., of his rights in the Exact-O-Matic System to territorial assignees during the years 1949 to 1951, inclusive, were taxable as a sale or exchange of a capital asset under Section 117 (a) of the Internal Revenue Code of 1939.

5. In failing to hold that the proceeds from the sale by petitioner, Joe L. Schmitt, Jr., of his rights in the Exact-O-Matic System to territorial assignees during the years 1949 to 1951, inclusive, were taxable as a sale or exchange of a capital asset under Section 117 (q) of the Internal Revenue Code of 1939, added by the Act of June 29, 1956, c. 464, 70 stat. 404.

6. In holding that petitioner retained in the aggregate such continuing rights and interest in the Exact-O-Matic System as to preclude recognizing the sales or assignments as sales.

7. In that its Opinion and Decision are not supported by the evidence.

8. In that its Opinion and Decision are contrary to law.

ARGUMENT

The proceeds from the sale of the Exact-O-Matic System to Territorial Assignees during the years here involved are taxable as capital gains.

The question for decision is whether petitioner conveyed all his "substantial rights" in the Exact-O-Matic System to the territorial assignees. The petitioner contends that he transferred all his "substantial rights." The Tax Court held that because certain rights were reserved the petitioner did not dispose of all his substantial rights in the Exact-O-Matic System. (R. 160-161) It is the petitioner's position that there was a sale or exchange of property within the definition of such sale or assignment as is set forth in the landmark case of *Waterman* v. *Mackenzie,* 138 U.S. 252, 34 L. Ed. 923, 11 S. Ct. 334, where it is said:

> " * * * The patentee or his assigns may, by instrument in writing, assign, grant and convey, either, 1st, the whole patent, comprising the exclusive right to make, use and vend the invention throughout the United States; or 2d, an undivided part or share of that exclusive right; or, 3d, the exclusive right under the patent within and throughout a specified part of the United States. * * * "

The law regarding the sale or exchange of patents is succinctly set forth in the case of *Watson* v. *United States,* (CA-10, 1955), 222 F. (2d) 689, 47 AFTR 925, as follows:

> "(1) It is a firmly accepted principle of law that if the patentee conveys by an instrument in writing the exclusive right to make, use, and vend the invention throughout the United States, or an undivided part or share of that exclusive right, or the exclusive right under the patent within a specified area within the United States, the conveyance constitutes an assignment of the patent, complete or partial as the case may be; and that a transfer short of that is not an assignment but a license. Waterman v. Mackenzie, 138 U.S. 252, 11 S.Ct. 334, 34 L.Ed. 923; United States

> v. General Electric Co., 272 U.S. 476, 47 S.Ct. 192, 71 L.Ed. 362; Doherty Research Co. v. Vickers Petroleum Co., 10 Cir., 80 F.2d 809, certiorari denied 299 U.S. 545, 57 S.Ct. 9, 81 L.Ed. 401; Broderick v. Neale, 10 Cir., 201 F.2d 621. In language too clear for doubt, the agreement into which Watson and O'Donnell entered expressly granted to Telescope Carts, Inc., the exclusive right to make, use, and vend the carts throughout the United States."

See also: *Rose Marie Reid,* 26 T.C. 622.

Applying the foregoing principles to the facts in the instant case, it can be seen that the petitioner transferred for value all of his rights in the Exact-O-Matic System throughout a specified area to the assignees. There was no time limitation on the grant. The assignees had the right to make, use and sell the Exact-O-Matic System within the meaning of *Waterman* v. *Mackenzie,* 138 U.S. 252, 34 L. Ed. 923, 11 S. Ct. 334. The assignees received both legal and equitable title to petitioner's rights without any possibility of reverter or termination except for nonpayment of the consideration set forth in the agreement.

The opinion of the Tax Court does not point out any particular right that was reserved by the petitioner that would prevent the transactions here involved from being a sale or exchange. Rather, the Court points out various rights of the parties to the contract and then concludes: (R. 160-161)

> "It is important to note that we do not rest our conclusion upon any one of petitioner's retained interests or powers, and, without doubt, there are cases in which the reservation of some similar powers and rights has been held not to be fatal. We hold that all of the rights, powers, and continuing interests reserved by petitioner, taken in combination, are of such character as to be inconsistent with a 'sale or exchange' of property by petitioner, and that Congress did not intend to confer the special benefits relating to sales of capital assets in such situations. * * *"

A realistic approach to the problem will show that the rights retained were not substantial and did not infringe upon the assignees' full enjoyment to make, use, and sell the Exact-O-Matic System within the specified territorial area conveyed to him. Some of the rights reserved were to insure full payment for the transfer involved. Other rights reserved were to protect not only the petitioner's interest in the System but to protect other assignees who had purchased the rights to use and sell the Exact-O-Matic System in other territories. It should be pointed out that petitioner as the assignor reserved no right of supervision, dominion or control over the assignee as owner of the Exact-O-Matic System in his territorial area.

The first reservation in the Territorial Assignment of Patent which the Tax Court points out as being a substantial limitation imposed upon the rights assigned to the territorial franchise holder is set forth in paragraph 15 of the Territorial Assignment of Patent. (R. 32, 156-157) Under paragraph 15 the assignee agrees not to assign or dispose of his territorial franchise in whole or in part without petitioner's written consent. The Tax Court does not discuss the evidence behind this provision. The record shows that the reason for the restriction is that the Exact-O-Matic System is a tool of the accounting profession. The intent behind this restriction was to see that the Exact-O-Matic System did not fall into the hands of persons who were professionally unsuited to use the system. Consequently, the intent was to protect the value of the system by maintaining high standards of skill and integrity in its overall operation. (R. 92) This provision was designed not only to protect the assignor but to protect other assignees who had purchased the rights to use and sell the Exact-O-Matic System in other territories. The fact that the transferee must obtain the consent of the transferor before licensing others to use a patent did not preclude a sale in the case of *Watson* v. *United States,* (CA-10, 1955) 222 F. (2d) 689, 47 AFTR 925. The con-

tract or assignment in that case contained a provision that the right of the licensee thereunder should not be assigned without the consent of the licensor having been obtained in writing. In discussing this provision requiring consent of the assignor for the assignment of the rights sold, the Court said:

> "The contract contained a further provision that the rights of the licensee thereunder should not be assigned without the consent of the licensor having been obtained in writing. That precautionary provision was intended to protect the rights of the parties under the contract, not to proscribe, limit, or nullify their intent and purpose to vest immediately in the transferee the right to manufacture, sell, and use the carts throughout the life of the patent, as well as any extension or extensions thereof. Platt v. Fire-Extinguisher Manufacturing Co., 3 Cir., 59 F. 897; Commissioner of Internal Revenue v. Celanese Corp., supra; Carl G. Dreymann, 11 T.C. 153."

In the case of *Rollman* v. *Commissioner*, (CA-4, 1957), 244 F. 2d 634, 51 AFTR 445, the taxpayers granted an exclusive license to their patents with a proviso against sub-licenses without their written consent. The Court of Appeals in reversing the Tax Court and holding the proceeds from the sale to be taxable as the sale of capital assets said:

> "Actually, the agreement provides that Rikol will not grant sub-licenses under the patents mentioned therein, *unless it shall first receive the written consent of The Rollmans.* In addition, Rikol is given the right to grant sub-licenses to corporations controlled by Wellco. The authorities do not support the view that the grant of exclusive rights under a patent does not amount to a transfer of a capital asset if the assignee cannot grant a sub-license without the assignor's consent. Such a limitation does not interfere with the full use of the patent by the assignee and it serves to protect both parties to the assignment in case the

purchase price is paid in instalments. Moreover, the assignor retains no use of the patent for himself by reason of the limitation since he has granted the exclusive rights to the assignee and cannot grant a sub-license without the purchaser's consent. See Allen v. Werner, 190 F.2d 840 (40 AFTR 1182) (CA 5); Watson v. United States, 222 F.2d 689 (47 AFTR 925) (CA 10); Platt v. Fire Extinguisher Mfg. Co., 59 Fed. 897 (CA 3); Crook et al Exrs. v. United States et al., 135 F.Supp. 242 (48 AFTR 546); First Nat'l Bank of Princeton Exr. v. United States, 136 F.Supp. 818 (48 AFTR 1082); Parke Davis Co. v. C.I.R., 31 BTA 427, 430; General Spring Corp. v. C.I.R., 12 TCM 847."

Other cases have held that certain limitations on assignments or licensing did not preclude a sale. See: *Allen* v. *Werner,* (CA-5, 1951), 190 F. 2d 840, 40 AFTR 1182; *Thompson* v. *Johnson,* (DC-NY, 1950), 42 AFTR 1284; *Arras* v. *United States,* 164 F. Supp. 150, 1 AFTR (2d) 1865; *First National Bank of Princeton* v. *United States,* (DC-NJ, 1955), 136 F. Supp. 818, 48 AFTR 1082; *Lamar* v. *Granger,* (USDC WD-Pa., 1951), 99 F. Supp. 17, 40 AFTR 1246; *Merck & Company, Inc.* v. *United States,* (DC-Penn., 1957), 155 F. Supp. 843, 52 AFTR 799; *Crook* v. *United States,* (DC-Penn., 1955), 135 F. Supp. 242, 48 AFTR 546; *General Spring Corp.*, ¶53,257 P-H Memo T.C.

The Tax Court points out petitioner reserved the right to terminate the franchise upon the holder's failure to make required payments. (R. 159) The right to terminate the agreement for a nonpayment is set forth in paragraph 8 of the Territorial Assignment of Patent (R. 28-29), and is a condition subsequent. It is the type of condition subsequent that was found to be consistent with vestiture of title in the case of *Commissioner* v. *Celanese Corp. of America,* (CA-DC, 1944), 140 F. 2d 339, 32 AFTR 42. See also: *Allen* v. *Werner,* (CA-5, 1951), 190 F. (2d) 840, 40 AFTR 1182; *Edward C. Myers,* 6 T.C. 258; *Lamar* v. *Granger,* (US-DC WD Pa., 1951), 99 Fed. Supp. 17, 40 AFTR 1246.

The possibility of reverter to the assignor because of a condition subsequent does not prevent a transaction from being a sale with the gain therefrom entitled to the benefits of Section 117 treatment. See also: *Allen* v. *Werner,* (CA-5, 1951), 190 F. 2d 840, 40 AFTR 1182; *Watson* v. *United States,* (CA-10, 1955), 222 F. 2d 689, 47 AFTR 925; *Lawrence* v. *United States,* (CA-5, 1957), 242 F. 2d 542, 50 AFTR 2024; *Kronner* v. *United States,* 126 Ct. Cls. 156, 110 F. Supp. 730; *Carl G. Dreymann,* 11 T.C. 153; *Monie S. Hudson,* ¶56,060, P-H Memo T.C.

An examination of the Territorial Assignment of Patent (R. 24-33) and the district franchise (R. 34-41) and the so-called reserved rights listed by the Court (R. 157-160) show that all rights, powers and interests reserved are insubstantial to a full and complete enjoyment by the assignee to make, use and sell the Exact-O-Matic System in the specified territory. In *Lawrence* v. *United States,* (CA-5, 1957), 242 Fed. 2d 542, 50 AFTR 2024, the taxpayer was the inventor of a device for removing obstructions from oil wells. He granted the exclusive right to manufacture, use and *lease* this invention in the United States. The taxpayer received royalty interest in payment for the transfer. The District Court held that this created a license rather than a sale, and, therefore, the proceeds were ordinary income because the right to sell was not included in the agreement. The Fifth Circuit reversed the District Court on appeal and held that the right to sell under the facts in that case was not a substantial right and said:

> "* * * What is 'substantial' often becomes a factual question to be decided according to the facts and circumstances of each case and the peculiarities inherent in each patent."

The foregoing shows that the particular matter which is the subject of the assignment must be given full consideration in determining whether "all of the substantial rights"

have been transferred to the assignee. The Tax Court in the instant case has ignored this principle. As previously pointed out, the Exact-O-Matic System is a tool of the accounting profession. Only professionally qualified accountants are suitable persons to use the system. The intent running throughout both the Territorial Assignment of Patent and the District Franchise was to see that the system did not fall into the hands of persons unqualified to use it. The intent was to protect the value of the system by maintaining high standards of skill and integrity in its overall operation. This provision was designed not only to protect the assignor but to protect other assignees who had purchased the right to use and sell the system in other territories. The Tax Court ignored the principle that "nature of the rights involved" must be given consideration in determining if "all the substantial rights" have been sold. This Court pointed out this rule in the case of *United States* v. *Carruthers,* (CA-9, 1955), 219 F. 2d 21, 46 AFTR 1626 as follows:

> "Aside from the several cases which treat an assignment of patent rights to a limited area as a sale for tax purposes, and the cases which regard the transfer of a part interest in a patent as a sale for tax purposes, there are cases not in conformity with the Waterman test which hold that the transfer of patent interests should be treated as long-term capital gains. Allen v. Werner, 5 Cir., 190 F.2d 840, 842 is a case involving a 'license' which was terminable on 90 days notice and which could not be assigned except upon transfer of the entire business. In holding that the taxpayer-patentee should be granted a tax refund on the basis that the receipt of royalties on this transfer of patent rights should be treated as a long-term capital gain rather than ordinary income, the court made this general observation:
>
> > 'The decisions consider the nature of the rights involved under a patent, and the interest of the assignor which require that proper effort to promote

> manufacture and sale of the patented article be provided and enforceable.' "

* * * * *

The Tax Court rests its conclusion that petitioner did not dispose of all of his substantial rights on the ground he retained, in the aggregate, too many rights. The only case cited by the Tax Court in support of this position is *Watkins* v. *United States,* (CA-2, 1958), 252 F. 2d 722, 1 AFTR 2d 997. The rights retained in the *Watkins* case clearly distinguish it from the case at bar. The rights reserved as listed in the opinion were:

> "Among the rights remaining in or bestowed upon Watkins by the various agreements were: (1) a right to royalties; (2) the power of termination in event of failure of the transferee to obtain necessary loans to conduct patent litigation; (3) Watkins' limited right to conduct patent litigation; (4) the restraint of nontransferability on the grant; (5) the fact that through the grant Watkins became a substantial shareholder in the transferee; (6) the reservation to Watkins of the license to manufacture and sell and to sublicense at reduced royalties and with a limited right of transferability; (7) Watkins' right to approve all sublicensees of the transferee."

The rights retained by petitioner in the case at bar were no more substantial than those contained in other cases involving assignments that resulted in capital gains treatment. In *Watson* v. *United States,* (CA-10, 1955), 222 F(2d) 689, 47 AFTR 925 the agreement provided: (1) that the licensee should not assign the exclusive rights to the patent without the licensor's written consent; (2) that the licensor would be free to license others to manufacture and sell the patented device should the licensee fail to make and sell 2,500 carts during a six-month period; (3) for payment of royalties; and (4) various provisions relating to suits for infringement.

In *Dairy Queen of Oklahoma, Inc.* v. *Commissioner,* (CA-10, 1957), 250 F(2d) 503, 52 AFTR 1092, reversing 26 T.C. 61, the Court held a sale occurred although many more rights were retained than in the case at bar. There a franchise agreement provided that the taxpayer would furnish freezers and a formula for an ice cream mix. Among the rights retained were the following:

1. The freezers remained the property of the assignor.
2. The assignee could only obtain ice cream mix from a source approved by assignor.
3. Assignee to furnish suitable location to be approved by assignor.
4. The store was to be of standard design and construction and the assignees agreed to maintain standards of quality regarding cones, cups, flavoring and miscellaneous supplies.
5. The assignee could sell no other product than Dairy Queen.
6. The assignor had the right to audit the records of the assignee.
7. The assignee could not sell a similar product for a period of five years in event of termination of the agreement.
8. The assignor had the right to enter and remove the freezer if licensee violated the agreement.
9. The assignee had to obtain prior approval of the assignor to transfer or assign the contract.

Notwithstanding these retained rights the Tenth Circuit in holding that the traditional test of ownership is the power to exclude others said:

> "(5) The requirements of the franchise with respect to maintenance of quality; sanitary dispensing conditions; design of stores; right to audit the books;

> approve source of 'mix'; and cancellation for violation of such requirements, were all intended to insure uniform standards for the trade name product sold statewide. So long as the grantee complied with these conditions subsequent, the grantor could not invade the grantee's exclusive right to make and sell the products in his designated territory. Each and all of these conditions were designed to protect and safeguard the respective rights of the parties. They were not intended to reserve to the grantor any property or proprietary right in the exclusive and perpetual franchise. Nor do we think the provisions with respect to the gallonage payments impair such exclusive right. Cf. Watson v. United States, supra."

See also: *Allen* v. *Werner,* (CA-5, 1951), 190 F.2d 840, 40 AFTR 1182; *Arras* v. *United States,* (D.C. Conn.; 1958), 164 F. Supp. 150, 1 AFTR 2d 1865.

The Tax Court held that Section 117(q) of the Internal Revenue Code of 1939 which was added by Act of Congress on June 29, 1956, c. 464, 70 Stat. 404, was not applicable because the section is limited to "patent rights" and because the transfers were not made with respect to "all substantial rights" in the Exact-O-Matic System. (R. 161) Under Section 117(q) the sale of "all substantial rights to a patent or an undivided interest therein which includes part of all such rights," by an inventor results in long-term capital gain or loss. This rule applies whether the inventor is an amateur or professional and whether the payments are in a lump sum or are periodic or contingent. The Amendment applies to receipts by an inventor in any taxable year beginning after May 31, 1950 regardless of the taxable year in which the sale or transfer occurred. The new section is substantially the same as Section 1235 of the Internal Revenue Code of 1954. The refusal of the Commissioner to follow the decision of the Tax Court in the case of *Myers* v. *Commissioner,* 6 T.C. 258, is the reason for the enactment of section 1235 of the Internal Revenue

Code of 1954 and Section 117(q) of the Internal Revenue Code of 1939. The cases listed below show that it is applicable to the case at bar. *Rollman* v. *Commissioner,* (CA-4, 1957), 244 F.2d 634, 51 AFTR 445; *Lawrence* v. *Commissioner,* (CA-5, 1957), 242 F.2d 542, 50 AFTR 2024; *Storm* v. *United States,* (CA-5, 1957), 243 F.2d 708, 51 AFTR 177; *F. H. Philbrick,* 27 T.C. 346 (1956). The legislative history of the section is reviewed in *F. H. Philbrick,* where it was stated:

> "The meaning of the phrase 'all substantial rights to a patent,' used in said subsection (q), is explained in the report of the Senate Finance Committee on the cognate provisions of Section 1235 of the 1954 Code, as follows:
>
> 'The section does not detail precisely what constitutes the formal components of a sale or exchange of patent rights beyond requiring that all substantial rights evidenced by the patent (other than the right to such periodic or contingent payments) should be transferred to the transferee for consideration. This requirement recognizes the basic criteria of a "sale or exchange" under existing law, with the exception noted relating to contingent payments, which exception is justified in the patent area for "holders" as herein defined. To illustrate, exclusive licenses to manufacture, use and sell for the life of the patent, are considered to be "sales or exchanges" because, in substantive effect, all "right, title, and interest" in the patent property is transferred (irrespective of the location of legal title or other formalities of language contained in the license agreement). Moreover, the courts have recognized that an exclusive license agreement in some instances may constitute a sale for tax purposes even where the right to "use" the invention has not been conveyed to the licensee, if it is shown that such failure did not represent the retention of a substantial right under the patent by the licensor. It is the intention of your committee to continue this realistic test, whereby the entire transaction, regardless of formalities, should be ex-

amined in its factual context to determine whether or not substantially all rights of the owner in the patent property have been released to the transferee, rather than recognizing less relevant verbal touchstones. The word "title" is not employed because the retention of bare legal title in a transaction involving an exclusive license may not represent the retention of a substantial right in the patent property by the transferor. Furthermore, retention by the transferor of rights in the property which are not of the nature of rights evidenced by the patent and which are not inconsistent with the passage of ownership, such as a security interest (e.g., a vendor's lien) or a reservation in the nature of a condition subsequent (e.g., a forfeiture on account of nonperformance) are not to be considered as such a retention as will defeat the applicability of this section. On the other hand, a transfer terminable at will by the transferor would not qualify.'

"The phrase 'rights to a patent,' appearing in said subsection (q), appears also in section 1235 of the 1954 Code. The reports of the Senate Finance Committee and of the Conference Committee on this latter section indicate that such phrase was substituted, in lieu of a previously suggested phrase reading 'rights evidenced by a patent,' in order to make clear that the section applied, even though the patent itself might not have been issued at the time of the transfer, and even though an application for the patent might not then have been made."

Under the Territorial Assignment of Patent, the assignee is given the right to license others to use the Exact-O-Matic System. This has been held to be evidence that there was a sale. See: *Monie S. Hudson*, ¶ 56,060 P-H Memo. T.C.; *Pike* v. *United States,* (DC-Conn., 1951), 101 F. Supp. 100, 41 AFTR 501. In addition, the Territorial Assignment of Patent in paragraph 13 shows the intent of the parties to be that the assignee is "the territorial owner of the patent, operating completely independent of the assignor." In view of this language in

the agreement, it is difficult to understand how it can be contended that the territorial assignee did not receive all of petitioner's right, title, and interest in the Exact-O-Matic System within the designated territory. The foregoing authorities lead to the inescapable conclusion that the Territorial Assignments of the Exact-O-Matic System in the instant case constituted a sale within the meaning of Section 117 of the Internal Revenue Code, and that the proceeds are taxable as capital gains rather than as ordinary income.

CONCLUSION

For the reasons stated above, the decision of the Tax Court should be reversed.

Respectfully submitted,

Robert Ash
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APPENDIX

Table of Exhibits

Exhibit		Page where Received in Evidence
1-A	Territorial Assignment of Patent (R. 24-33)	55
2-B	District Franchise (R. 34-42)	55
3-C	Schedule of Receipts of Money (R. 43)	55
4-D	Agreement (R. 44-48)	55
23	Computation of Amount due Exact-O-Matic Sytem of Arizona, Inc. (R. 97-98)	96–97